



MICHAEL J. MURPHY
State Treasurer

Fourth Quarter 2004

The QUARTERLY

Local Government Investment Pool

LGIP staff

Michael J. Murphy
State Treasurer
(360) 902-9001

Michael Colleran
Assistant Treasurer
(360) 902-9002

Douglas Extine
Deputy Treasurer
(360) 902-9012

Jen Thun
LGIP Administrator
1-800-331-3284

Mary Pheasant
Administrative Support
(360) 902-9004

www.tre.wa.gov

Will the Fed continue raising rates?

Fed Chairman Alan Greenspan has said that rates will rise in order to bring monetary policy in line with economic reality. The economic reality that seems not too obvious at the moment is the fact that growth has started to accelerate with inflationary pressures not far behind. In its December meeting, the FOMC (Federal Open Market Committee) was unanimous that interest rates were still low. The Fed also reiterated that the level of the real funds rate remained below the level to keep inflation stable and output at its potential.

Inflation, although still manageable, could be a risk to stable growth. The Fed pointed out the nation's solid economic recovery and the obvious cost and price pressures associated with economic growth. The Fed repeated the need to raise rates to stave off any inflation threat. The confluence of a weaker U.S. dollar, higher energy prices and reduced competition in some industries are factors that could trigger higher inflation.

One immediate Fed concern is the current excessive speculation in asset markets. As proof that interest rates are still low, the Fed warned that... "the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow spreads, a pick-up in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that speculative demands were becoming apparent in the market of family homes and condominiums."

The above statement is the second Fed warning since the Nov. 19 statement of Greenspan that said "...rising interest rates have been advertised for so long and in so many places that anyone who has not appropriately hedged this position by now obviously is desirous of losing money."

The repeated warnings of Fed officials should serve as advance notice of the Fed's intention to keep raising rates as it deems necessary to avoid inflation from stunting the nascent economic growth.

The FOMC meeting and the "measured" language

The FOMC decided to raise fed fund rates to 2.5 percent at its Feb. 2 meeting and reiterated the plan to maintain a "measured" pace to keep inflation at bay. The FOMC released a statement after the meeting saying that "... with the underlying inflation expected to be relatively low, the committee believes that policy accommodation can be removed at a pace that is likely to be measured." The rate hike is the Fed's sixth consecutive in this round of hikes, which started in June 2004.

Most investors believe the Fed will continue hiking rates 25 basis points (bp) at each meeting until rates settle at 4-4.25 percent by year's end. Fed officials have been trying to raise rates to achieve a neutral level of interest rates in synch with a growing economy. The "neutral" rate is where interest rate levels do not stimulate or choke off

continued on page 2

Market summary

from page 1

the economy.

Inflation has remained stable as the economy continues its fourth year of recovery from recession. The Fed's preferred core PCE price measure has gone up around the 1.50 percent level for most of FY 2004 from its lowest level of 1 percent in 2003 when fears of deflation became very rampant. The core PCE at the current level has eliminated deflation fears but has now brought on fears of rising inflation. The real fed funds rate based on core PCE prices stands at 1 percent. This level is still very accommodative judging from FOMC members' comments.

The Fed needs to find a balance in order to reach its stated goal of "price stability." It is obvious that a 1 percent real fed funds rate would not be where the Fed could retain a "neutral" risks assessment of inflation. The recent release of the Fed Beige book suggests that growth continues to expand in all sectors of the economy. The Fed seems to be unperturbed by the rise in energy prices as they mentioned that "output appears to be growing at a moderate pace despite the rise in energy prices, and the labor market continues to improve gradually." The underlying growth is supported by productivity. The Fed believes that in this kind of environment, growth objectives could be attained with inflation stable.

Mixed economic numbers, however, suggest that growth is still uneven. The Fed hopes to take away monetary accommodation without nipping the buds of economic growth. Thus, the "measured" pace seems to be the logical move at the moment. The economic data moving forward will determine if the Fed needs to keep hiking rates and subsequently, the pace of the rate hikes.

Some investors are betting that the continued rate hike scenario may not happen if economic growth stalls in the middle of

2005. Market watchers are closely looking at a slowdown in inflation, consumer spending, housing outlays and uneven labor markets as some credible reasons for the Fed to pause at least once during the course of the year.

Economic growth

The economy is forecast to grow between 3.6 and 4 percent after a 4.4 percent expansion last year. The economy faces a huge trade deficit, which took 1.7 percentage points from the GDP in fourth quarter 2004. A weakening U.S. dollar could arrest the drag from the deficit if it boosts export figures. Greenspan, in his last speech, mentioned that exports need to grow 50 percent as quickly as imports just to keep the trade deficit from widening.

The GDP estimate for 2005 seems to be lackluster compared to 2004, but at 3.75 to 4 percent (Fed Central Tendency Forecast) is nonetheless robust. The U.S. is banking on consumer spending, business spending, and inventory building as major factors to offset the effects brought about by trade and current account deficits. Consumer spending, which accounts for more than two-thirds of the GDP, has continued its impressive run, growing 4.6 percent annually.

The caveat to recovery is how interest rates affect consumption and if inflation remains manageable. Rising interest rates have not put a dent in consumer sentiment and mortgage rates have been manageable until this quarter. Homebuyers are still encouraged by low rates, loan advances and cash-out refinancing. If the Fed continues hiking rates, decreasing consumer demand could pose a significant risk to economic growth. Debt burdens of ordinary consumers are high, and low personal saving rates could have a deleterious effect on household finances.

The Fed is trying to bring interest rates

LGIP Advisory Committee

Dani Burton

Klickitat County Treasurer
(509) 773-4664

Stan Finkelstein

Assn. of Washington Cities
(360) 753-4137

Lisa Frazier

Mason County Treasurer
(360) 427-9670 (Ext 484)

Chuck Greenough

State Board for Community and Technical Colleges
(360) 704-4380

Paula Henderson

City of Des Moines
(206) 870-6512

Lynn Hills

Port of Bremerton
(360) 674-2381

Richard Patrick

City of Burlington
(360) 755-0531

Shelley Pearson

Kitsap Co. Investment Offcr.
(360) 337-7139

Barbara Stephenson

Kitsap County Treasurer
(360) 337-7136

Dan Underwood

City of Richland
(509) 942-7302

Linda Wolverton

Spokane County Treasurer
(509) 477-4786

Mark Wyman

Snohomish County PUD
(425) 783-8317

continued on page 3

**Also offered by the
Office of the State
Treasurer. . .**

LOCAL Program

Financing solutions for
local government equip-
ment and real estate
needs.

**[www.tre.wa.gov/
local.htm](http://www.tre.wa.gov/local.htm)**

Contacts:

Sue Melvin
Equipment specialist
360-902-9022

Kristi Wolgamot
Real estate specialist
360-902-9020

Pam Johnson
LOCAL specialist
360-902-9021

Market summary

continued

to a neutral level in order to maintain price stability and economic growth. Inflation has not shown any imminent threat yet. Energy prices, wage cost pressures and the pricing power of manufacturers are key determinants that the market is watching closely. The net data that relate to inflation have been moving higher, which will keep the pressure on the Fed to keep raising rates.

Non-farm payrolls

January non-farm payrolls rose only 146,000 after downward revisions in each of the previous three months totaling 59,000. Most economists expected a higher number as a host of economic indicators suggested a strong growth momentum. Investors discounted the numbers due to seasonal factors and suggested that February numbers might lead to a credible picture of jobs growth.

The unemployment rate fell to 5.20 percent from 5.40 percent but this was mainly due to a lower participation rate of job seekers. One thing investors are watching is the rise in unit labor costs when productivity growth has moderated. Clearly, this leaves the market looking for more data that could change its view about the Fed's orderly rate hike.

The bond market

Despite the rise in the fed funds rate by 150 bp since last year, bond yields especially in the longer end of the curve have been resilient enough to stave off any increases. The entire yield curve has gotten flatter. Most of this flattening could be attributed to perceptions of the Fed's 'measured' pace and the market's belief that inflation is still low and manageable. However, part of the answer to this phenomenon could also be the fact that the market has been driven by more technical underpinnings than Fed expectations.

The market knows that the Fed will continue to hike interest rates until they reach

a neutral level to fend off any inflation threat. Even the threat of higher rates has not scared both domestic and foreign investors from putting money into the fixed income market. The threat of higher rates and more cash assets to be invested has prompted investors to keep duration short, with a bias to employ yield curve flattening trades.

Yield curve flattening trades are trades that benefit investors buying the long-dated bonds over short-term notes as yields on shorter maturities rise faster than longer-dated bonds at a time when the Fed is raising rates. It is profitable for these investors to short the front-end knowing that the Fed will continue raising rates and position in the longer end of the curve to enjoy the carry. The total return generated by yield curve flatteners has outweighed the inherent risk because the 10-year yields have been stuck in a solid range of 4 to 4.35 percent.

The front end of the curve has seriously underperformed the market. The two-year yield has gone up from 2.5 percent in October to its current high of 3.4 percent. Technical factors will continue to dictate the nature of the front-end yields.

In the grab-for-yield situation, agency spreads were tighter during the quarter versus treasuries and even wider versus swaps. Agencies outperformed treasuries despite bullet issuance and headline risk (GSE oversight reform). Market analysts believe that the supply of FNMA/FHLMC papers may shrink as both companies are planning to adjust their minimum capital held for compliance. The agency market is still characterized by strong demand even with spreads so tight. As long as there is money to be put to work, the yield curve could maintain its flattening bias. The market is waiting for any sign that could force investors to revert back to steepeners.

<HELP> for explanation.

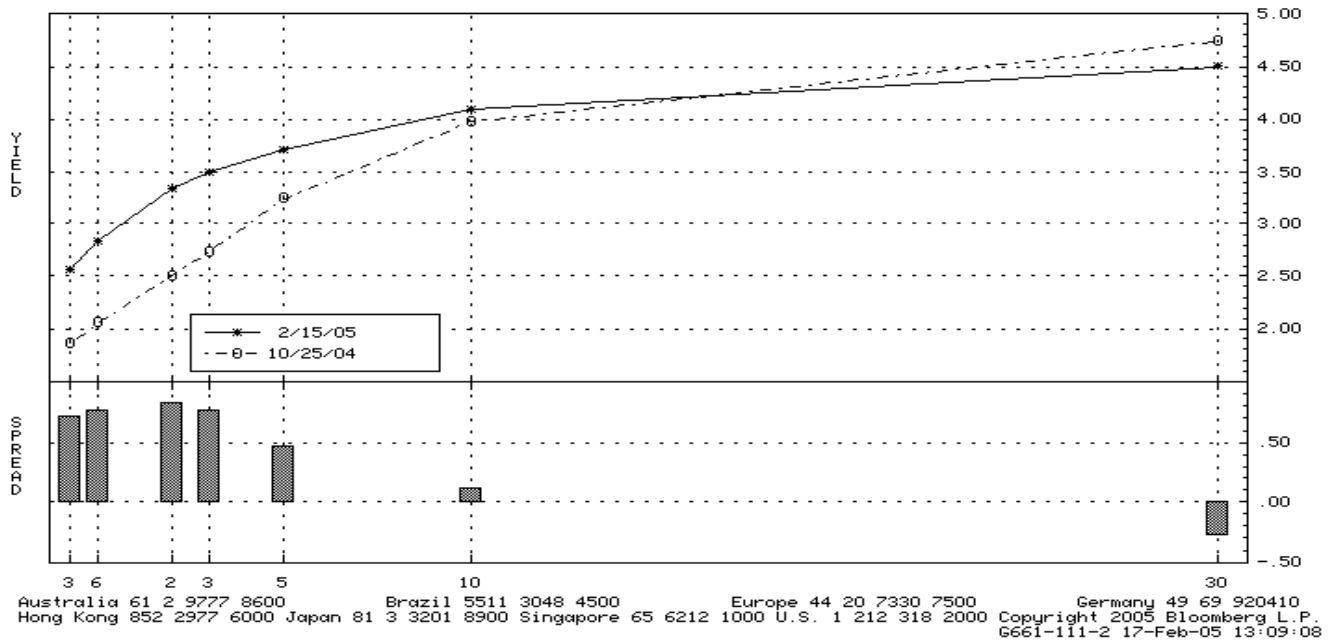
P110 Govt C15

HISTORICAL YIELD CURVE

PAGE 1 OF 2

DATE RANGE 10/25/04 2/15/05

MTY RANGE 3M 30Y



From the LGIP Administrator's Desk

By Jen Thun

Recently our Information Systems section evaluated the logons for the Treasury Management System (TM\$) and found that many people have not logged on to TM\$ in the last four years. Because of the costs associated with maintaining these logons, we have removed 125 old logons from the system that have never been used or not used since 2001. These deleted logons were issued to participants for the LGIP's previous view-only system who did not update their logons when full-access capabilities were added in 2002.

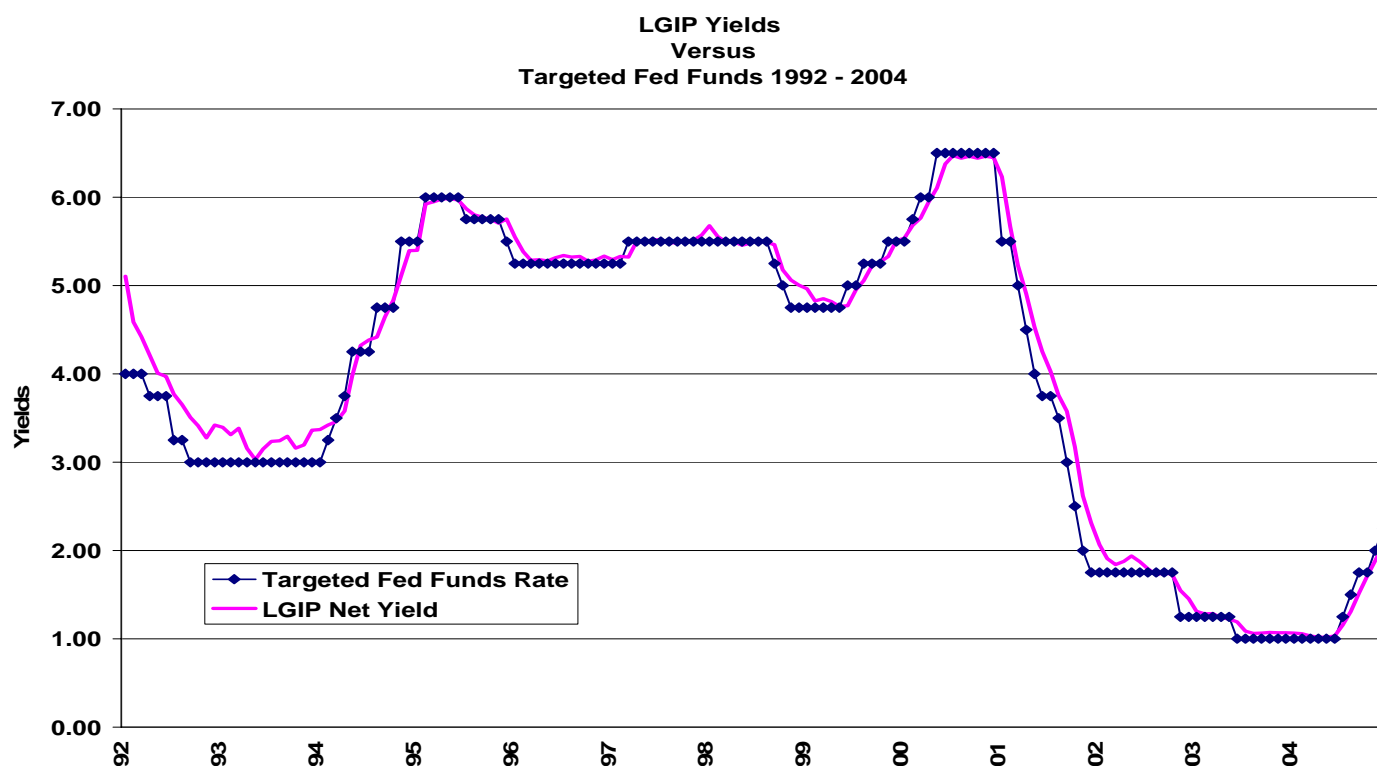
We want to assure you that this will not affect your TM\$ logon as long as you have a full-access logon and/or have logged on to TM\$ at least once since 2001. If you have any questions or concerns regarding this, or if you would like to request a TM\$ logon, please contact Jen Thun at 1-800-331-3284.

LGIP yields – Where do we go from here?

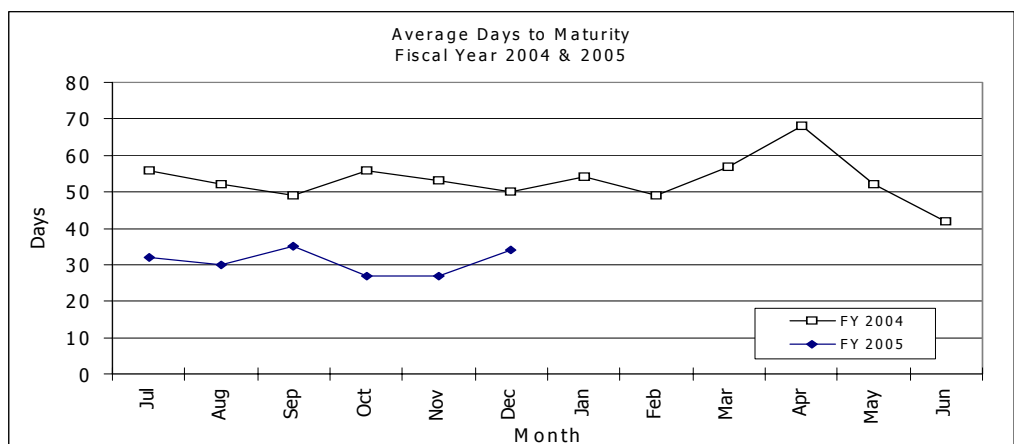
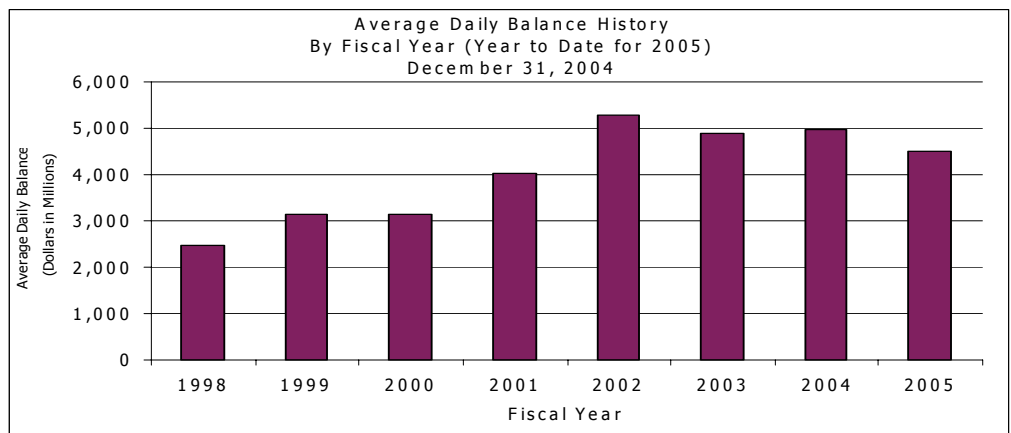
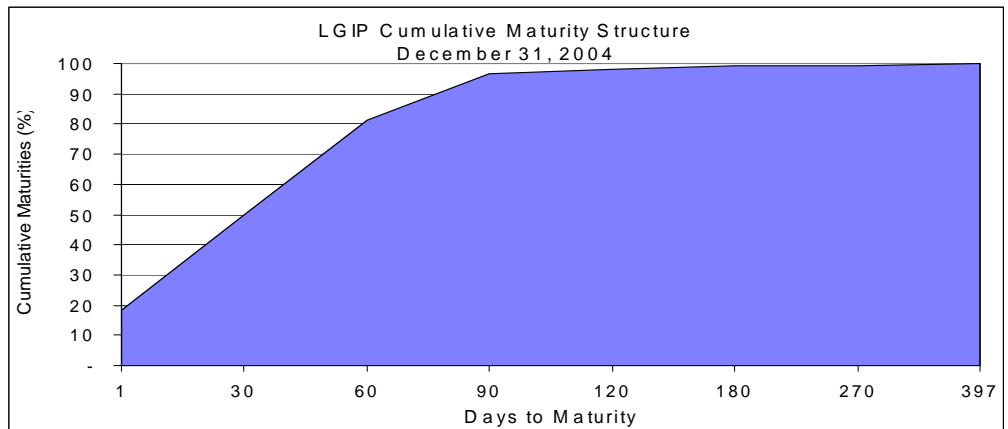
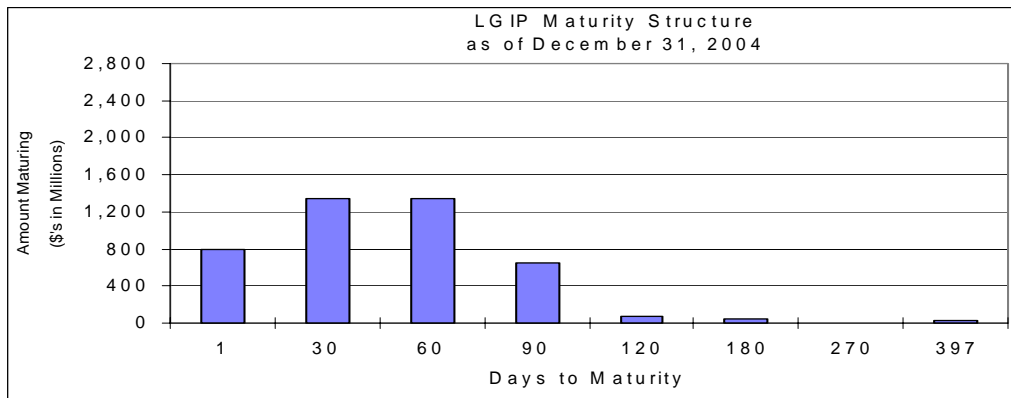
As LGIP participants have noticed, the LGIP yields have been steadily increasing each month to a January 2005 level of 2.22 percent, after spending all of fiscal year 2004 at levels close to 1 percent. Participants may be asking questions like ... what is going on?; will yields continue to rise?; how long will they rise?; and to what levels? While these are certainly valid questions we can provide answers to only some of them. In the Third Quarter 2002 issue of The Quarterly there was an article titled "The Targeted Federal Funds Rate – A Gauge of LGIP Rates." In light of the significant changes in the LGIP yields we felt that it was appropriate to reiterate some of what we presented in that article.

The LGIP is comparable to a Rule 2a-7 money market fund recognized by the Securities and Exchange Commission. This means the LGIP's investments are limited to high-quality obligations with limited maximum and average maturities, which minimizes both market and credit risk. As a result of these restrictions, the LGIP's investments are closely linked to the targeted funds rate. Furthermore, the short maturity structure means the yield of the LGIP will change fairly quickly when the FOMC changes the fed funds rate. However, because the LGIP portfolio generally has an average life of between 30 and 70 days, and the targeted fed funds will change immediately upon the FOMC pronouncement of any change, the LGIP yield will lag changes in the funds rate. The bottom line is that the LGIP yield will never depart very far from the targeted funds rate.

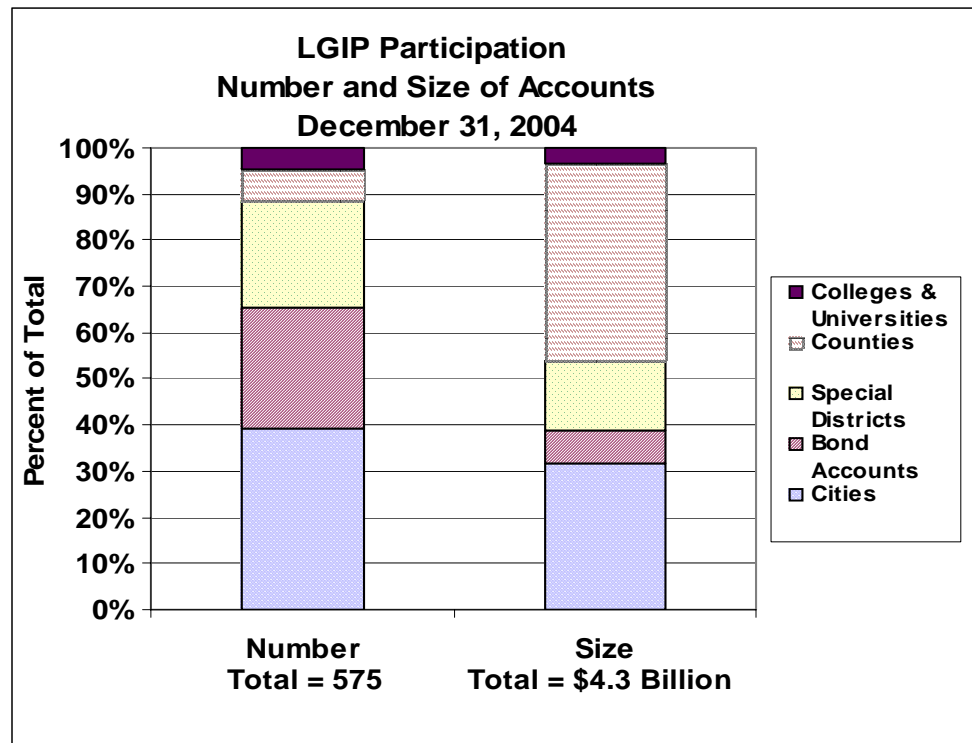
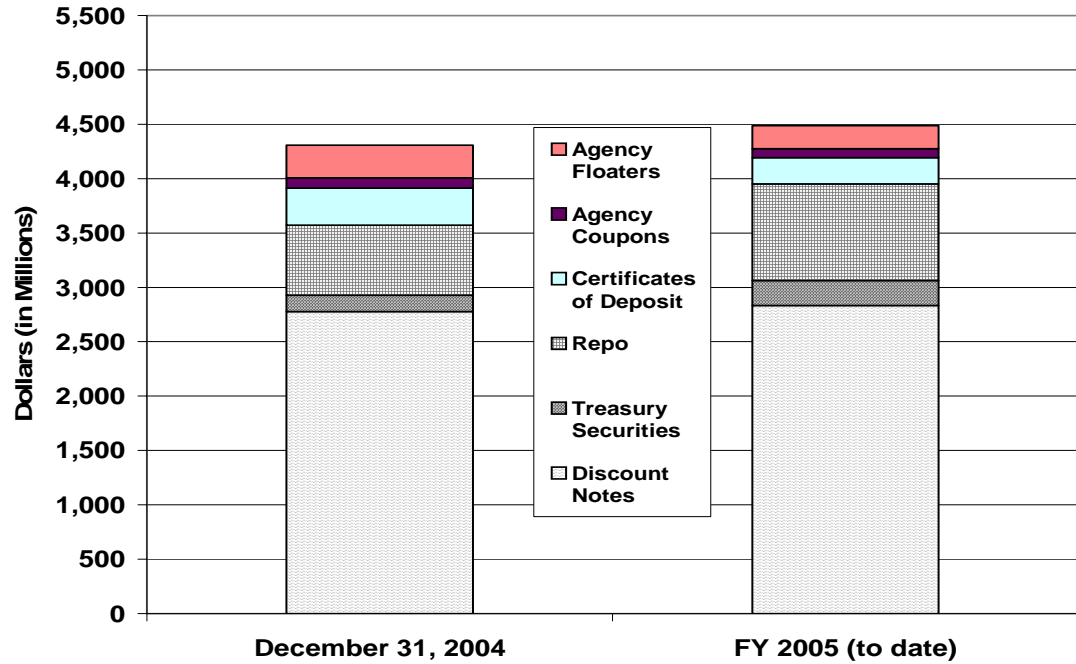
The graph below shows how closely the LGIP yields have tracked the targeted fed funds rate over the last 13 years. At this point we do not see any reason for this relationship to change. While no one can forecast interest rates, by keeping an eye on the targeted fed funds rate and statements by the Fed that provide indications of future Fed actions, participants can form reasonable expectations for future LGIP yields.



The portfolio management strategy currently in place for the LGIP portfolio is based on the anticipation of further rate hikes by the Fed. Accordingly, we are maintaining a fairly short average life of about 30 days in an effort to reprice as quickly as possible to the increasing fed funds rate.



**Portfolio Composition
Average Balance by Security Class**



Notes from the January 28 advisory committee meeting

The LGIP Advisory Committee met January 28. A brief report was given on Investment Team staffing changes. Lisa Hennessy, who was the LGIP portfolio manager, has been reassigned to the Cash Management Division. Doug Extine will manage the portfolio on an interim basis.

A brief update was given on the net LGIP returns for October through December. The net rate in December 2004 was almost double the rate in December 2003. The Fed tightened the fed funds rate to 2.25 percent and is expected to move to 2.50 percent at the next FOMC meeting. The LGIP has outperformed its benchmark, iMoneyNet, Inc., by an average of 41 basis points during 2004. The average net return for the LGIP was 1.323 percent, whereas for iMoneyNet, Inc., the net return was 0.9148 percent.

The strategy for the management of the LGIP portfolio was discussed. The portfolio has an average life of 28-29 days. The strategy is to keep short in anticipation of continued fed fund increases.

A handout was distributed to committee members describing LGIP month-end balance activity and daily balance activity for FY 2004 and FY 2005. Balances are declining but should start increasing in the months of April and May, as they did in FY 2004. The balance currently is \$3.85 billion whereas the average balance for FY 2004 was \$4.3 billion.

OST staff and advisory committee members discussed proposed legislative changes im-

pacting investors of public funds as well as other investment issues.

A brief update on TM\$ was given. It was reported that 70 percent of all transactions during the last quarter were made through TM\$. The old view-only logons from FY 2000 will be deleted from the system for individuals who have not accessed TM\$ for the past five years. There were no overdrafts from November 2004 to January 2005.

A brief update was given on the custody and securities lending services provided by The Bank of New York (BONY). With BONY as the custody provider, the LGIP custody costs are only about \$20,000 per year, which is \$100,000 less than under the previous contract. The contract will expire in October 2005 and BONY has indicated that they would offer a two-year extension with no additional fees. Based on BONY's performance and the attractive fee schedule, OST will pursue a two-year contract extension.

The FY 2005 budget was reviewed utilizing a handout provided to committee members. The estimate of fees and overdraft charges collected of \$1,506,324 is slightly higher than the original estimate of \$1,404,000, and the expenses of \$569,909 are lower than the original estimate of \$579,000. The estimated rebate for FY 2005 is now \$936,415, which exceeds the original estimate of \$825,000 by \$111,415.

LGIP Holiday Schedule for 2005

The Local Government Investment Pool will be closed on the following days:

Monday	May 30	Memorial Day
Monday	July 4	Independence Day
Monday	September 5	Labor Day
Monday	October 10	Columbus Day
Friday	November 11	Veteran's Day
Thurs/Fri	November 24-25	Thanksgiving holiday
Monday	December 26	Christmas

Washington State Local Government Investment Pool
Position and Compliance Report
as of 12/31/2004
(Settlement Date Basis)
(in Thousands)

LGIP Portfolio Holdings

	Cost	Percentage of Portfolio
U. S. Agencies	\$ 94,945	2.21
U. S. Callables	45,000	1.05
U.S. Agency Generic FRN	299,993	7.00
Certificate of Deposit	117,250	2.73
Discount Notes	2,906,897	67.79
Interest Bearing Bank Deposits	155,650	3.63
Repurchase Agreements	517,724	12.07
U.S. Treasuries	150,418	3.51
*Total Excluding Securities Lending	4,287,877	100.00

Securities Lending Holdings

Repurchase Agreements	188,614
Total Securities Lending	188,614

**Total Investments &
Certificates of Deposit**

\$ 4,476,490

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

	Portfolio Holdings	Percentage	Policy Percentage
Total Floating and Variable Rate Notes	299,993	7.00	30%
Variable Rate Notes w/maturities > 397 days	-	0.00	10%
Other Structured Notes	45,000	1.05	10%
Certificates of Deposit	117,250	2.73	10%
Leverage - Sec Lend + Rev Repo	185,791	4.33	30%

Maturity Limitations (Days)

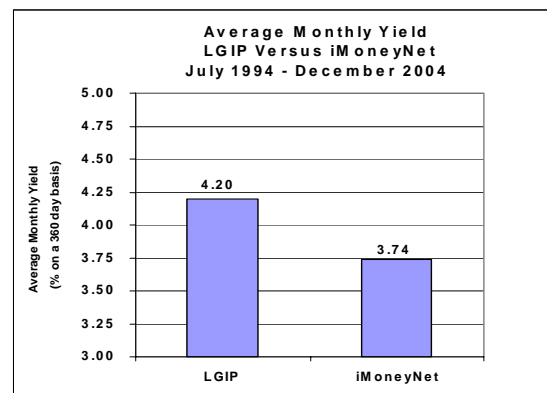
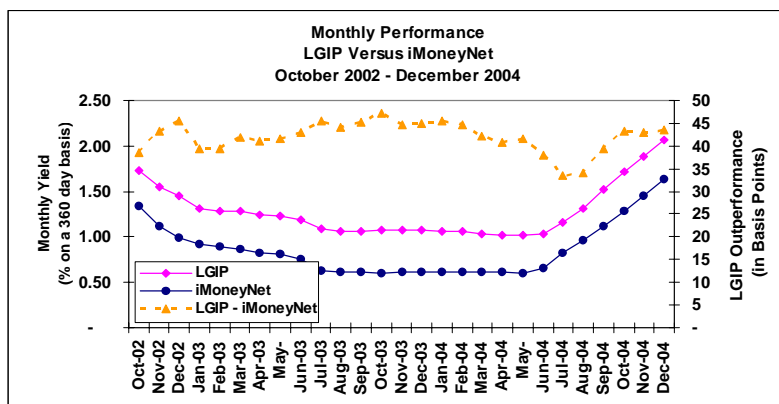
	Currently	Policy
Weighted Average Maturity	34	90
Maximum Final Maturity		
Bullet Securities	304	397
Variable and Floating Rate Securities	481	762
Repos	3	180
Reverse Repos	0	90

Repo Limits Per Dealer

		Total Repo Percentage	Term Repo Percentage	Projected Redemptions	Projected Position
	December 31, 2004	(20% limit)	(10% limit)	1/3/2005	1/3/2005
Banc America Securities	\$ 325,000	7.58%	0.00%	325,000	-
Bear Stearns & Co.	1,565	0.04%	0.00%	1,565	-
Goldman Sachs	98,092	2.29%	0.00%	98,092	-
Lehman Brothers Inc.	192,724	4.49%	0.00%	192,724	-
Morgan Stanley Dean Witt	88,957	2.07%	0.00%	88,957	-
Total	\$ 706,338			706,338	-

LGIP Performance Comparison

iMoneyNet, Inc.¹ versus Local Government Investment Pool



The chart on the left shows a monthly comparison from October 2002 through December 2004 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to December 2004. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 46.5 basis points. This translates into the LGIP earning \$165.78 million over what the average comparable private money fund would have generated.

¹ Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Local Government Investment Pool

STATEMENT OF NET ASSETS

December 31, 2004

(in Thousands)

Assets

Investments, at Amortized Cost:	
Repurchase Agreements	\$ 517,724
U.S. Agency Securities	3,346,835
U.S. Treasury Securities	150,418
Total Excluding Securities Lending	4,014,977

Securities Lending Investments, at amortized cost:	
Repurchase Agreements	188,614
Total Securities Lending	188,614
Total Investments	
(Settlement and Trade Date Basis)	4,203,591

Interest Bearing Bank Deposits	155,650
Certificates of Deposit	117,250
Cash
Interest Receivable	3,206
Total Other Assets	276,106
Total Assets	4,479,697

Liabilities

Accrued Expenses	302
Obligations under Securities Lending Agreement	188,614
Total Liabilities	188,916

Net Assets	\$ 4,290,781
-------------------	---------------------

Total Amortized Cost - Settlement Date Basis	\$ 4,476,491
--	--------------

QUARTER AT A GLANCE

October 1, 2004 to December 31, 2004

(in Thousands)

Total investment purchases:	\$ 28,894,969
Total investment sales:	\$ 269,844
Total investment maturities:	\$ 28,999,334
Total net income:	\$ 22,221
Net of realized gains and losses:	\$ 8
Net Portfolio yield (360-day basis):	
	October 1.7141%
	November 1.8810%
	December 2.0740%
Average weighted days to maturity:	34 days

WASHINGTON STATE LOCAL GOVERNMENT INVESTMENT POOL
OFFICE OF THE STATE TREASURER
PO BOX 40200
OLYMPIA WA 98504-0200

RETURN SERVICE REQUESTED

PRSRT STD
U.S. Postage Paid
Olympia WA
Permit No. 179



Legislative Building, PO Box 40200, Olympia WA 98504-0200

Toll Free (800) 331-3284 * TDD (360) 902-8963 * FAX (360) 902-9044

Home Page <http://tre.wa.gov>